Lending and Credit Monitoring Principles

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The results of a bank's activities depend to a significant extent on the quality of the credit portfolio that it holds, as well as on the credit tracking and control system. The purpose and functioning of such inter-banking systems differs from one bank to another. Loans require an increasingly efficient type of internal surveillance of activity. Following the clients' behavior and performances, as well as their entire activity is a particularly important phase and absolutely necessary in the course of a loan. The purpose of this activity is, generally, that of identifying, as early as possible, of clues about any problems that may appear during the course of the loan, so as to make possible, as early as can be, the taking of remedial measures with a view to anticipate the deterioration of the loan's debt. An open communication between the bank and the loan's beneficiary is an essential condition for an efficient tracking program. Another basic element is the rigorous and complete filling out of the credit papers. The credit files are the backbone of the loan monitoring process because these contain all of the documents which may offer to the credit officer, accounting expert, as well as other interested parties a permanent, chronological record of the loan relation.

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1. Introduction

From the approval and issuing of a bank loan and to its full reimbursement along with all corresponding debts, the purpose of the activity of tracking its course is to maintain, for the full extent of the crediting process, the initial conditions for its granting, in order to prevent that an initially well performing credit become underperforming due to the deterioration of the borrower's economic-financial situation. Credit monitoring will be done at the branch level by the credit inspector in a practical manner based on a plan established by the credit committee of the branch. The tracking is usually monthly or as often as is needed, meaning any time there is information that the economic-financial situation of the economic agent is on a declining trend.

Credit monitoring programs that a bank undertakes must include:

- periodical analysis of all loans or selected loans, in order to ensure that they follow the bank's loaning policy, the requirements of the documentation and the profitability conditions;
- classification of credits according to performance, by calculating the key indicators;
- accounting examinations through which the quality of the credit portfolio held by the bank is determined.

The credit officer has a determining role in establishing an efficient system of communication between the bank and the loan beneficiary, in developing the loan files, in leading or participating in loan analysis, in classifying loans as well as in running accounting examinations. Due to the fact that the credit officer is the only person in the bank that comes into direct contact with the client during all phases of the loaning process, he is the most qualified to anticipate possible problems and, along with the client, to find solutions for solving them. As a consequence, a weakly prepared credit officer who does not do his job thoroughly, may cause the failure of a credit monitoring program, regardless of how comprehensive and well elaborated it may be.

2. Communication between the credit officer and the client

From the moment a loan is issues, the bank must maintain a permanent contact with the recipient of the loan, meaning to develop the relationship that was established during the preliminary discussions, during the analysis and the approval of the loan demand. Many clients appreciate the fact that, from time to time, by phone, the credit officer asks about how they undertake their activity. Periodic telephone contacts and visits to the office of the beneficiary constitute a prudent practice of credit monitoring and, at the same time, a good relationship between the bank and the client.
Discussions by telephone can constitute an encouraging factor for a reciprocal communication between the bank and the client. It is much more probable that a client who is faced with financial decline will let the bank know about it if the credit offices had an open attitude in the past, manifesting his goodwill and willingness to help. Communication can be written, by phone, by visiting the office of the company or through social events, such as a business lunch. In all cases, the purpose is to keep open the lines of communication between the bank and the client. The credit officer must create a trustworthy and cooperative atmosphere. There is no substitute for an open and honest dialogue between the bank and the loan recipient. If the link between the bank and the client is good, an experienced credit officer can oft times reconstitute the real situation of a credit account, whether or not the client is truthful.

A great number of conclusions may be drawn from monitoring of a client’s current account and of the practiced modes of payment. For example, when the current account presents a growth of debtor balance or when the payment of interest and installment for an investment loan is outstanding, special attention must be given to that respective client. These evolutions may signal liquidity problems which may be caused by the late or absent collection of due claims, too much immobilization in unmarketable stock or the loss of an important client. When a major change appears in the payment modes practice by the client, the credit officer must make an additional analysis. A good practice in credit administration is the contacting by the bank of some of the client’s contributors, such as the accountant, the accounting expert or the financial consultant, who may supply relevant information. The credit officer must sometimes make the effort of visiting the client’s firm. An inspection of the location where the client’s economic activity takes place can reveal certain organizational or operational problems. The best method of accurately evaluation the condition and value of the assets the client owns is, in the case of a responsible credit officer, personal evaluation and not that based on the reports of colleagues. A location visit also creates the possibility to check any other securities left in the possession of the client, whether or not these are being stocked or maintained adequately.

A determinant role in the development, filling out and bringing up to date of the loan file of each client is played by the credit officer. The loan credit is a written account of the relations between the bank and the loan beneficiaries and is indispensable for the smooth running of the loaning process. Practically, any bank employee involved in the lending activity has, sooner or later, the opportunity to refer to the loan file. The bank’s jurists use it in the eventuality of litigation or when they have to verify or clarify certain judicial problems and accounting experts use such a file as the primary source of information when analyzing a loan relation. It is obvious that an adequate loan file can contribute to the improving of the quality of the loan and the minimization of risks. The credit officer which builds an incomplete and disorderly registering of data referring to the client’s activity cannot identify and track financial trends that may indicate the appearance of an underperforming loan. The credit officer, whose credit files are thorough and well organized, can react promptly and in accordance with the information at his disposal.

Still, the fact that the credit officer bears the principal responsibility for the loan file does not mean that this may be built as though the officer was its only user. The relationship is between the client and the bank, not the client and the credit officer. Any employee of the bank must have access to the loan file, in order to quickly find the information they need. In each bank there is a proprietary system of building loan files. Regardless of the disposition, it is important that these files be well built and follow a consistent development process. Unclear annotations, abbreviations or notes that don’t make sense will be of no use except, maybe, to the one who made them.

The information kept within loan files are grouped in several categories, as follows: loan documents; financial information; securities; correspondence, reports and notes; other material.

3. Bank credit control and measures that may be taken

Due to the fact that of the total funds used by the economic agents, credits have a significant portion, commercial banks have the right to not only check their use of loans but also the main sides of their activity. Bank checks of issued loans are exercised both on the basis of the documentation as well as on the basis of a concrete verification of the debtors’ situation. This control is differentiated according along the lines of two large categories of loans: short term loans and medium and long term loans.

For short term loans, document verification is done monthly, based on data from the balance sheet and patrimonial data. Still, for debtor firms that don’t have outstanding loans, interests or payments, control may be each trimester. On the basis of the data from the aforementioned documents, the short term loan security is developed. Thus, if following the check, a loss of security results, the client will have to reimburse loan installments equal to the amount of security loss, and if the debtor doesn’t have liquidity, the security loss is transformed in an outstanding loan with penalizing interest. Loan control is done mainly in the case of unsecured loans, that is to say, in case of security loss.

Following the control, the leadership of the bank is presented with situations which encompass the inspective analysis of the debtor, proposals for the secession of loaning and solutions for recovering
outstanding loans. If they exist, security surpluses are taken into consideration for the issuing of possible future, supplemented loans.

In the case of medium and long term loans, there is also a document based and an inspection based control. The first is done both during the execution of the investment project but also after the objective is engaged, up to the reimbursement of the loan. The control takes place both through payment documents and proprietary resource documents as well as the check balance, financial results, fiscal obligations, patrimony status, main economic-financial indicators and other documents presented by the debtor firm during the execution of the project. Based on the results of the controls, credit inspectors make proposals for measures which are approved by the bank’s leadership, namely:
- the classification of used loans as outstanding, for the corresponding lowering of the loan limit and recovering of respective loans from the clients income and liquid assets before any other payments, with the exception of salaries which have priority according to Law no. 53/2003 (Codul Muncii), modified and republished;
- the annulment or reduction of the approved loan in the case it is ascertained that the debtor has presented the bank with false data for determining the client’s quantum. This measure is taken only after the expiration of the 5 day written warning term;
- immediate suspension, without warning, of the granting of new loan installments; the loan that is used for other purposes, with its corresponding interest is immediately withdrawn from the debtor's liquid assets account and when this is not possible, it passes into outstanding status;
- the suspension without warning of the loan process in the case when the economic and financial situation of the debtor registers levels below those taken into account at the moment of initial issuing and that no longer ensure reimbursement conditions; the bank may rethink this measure after the client’s situation is redressed;
- the immediate withdrawal of the credit and owed interest from the liquid assets account of the debtor, and when this is not possible, repo measures will be taken to recover the loan;
- for loans that were under the competence of the main headquarters, the Credit Department will be informed on the measures taken;
- following their approval, established measures will be communicated in writing to the debtor within 5 days.

4. The purposes of loan portfolio analysis

The loan portfolio of a bank is made up of thousands of issued loans. During their course some loans prove to not have important risks, and others can deviate from the banks' loaning policies. In order to prevent such situations, as well as the appearance of other risks, banks must undertake a periodic analysis of the loans it holds in its portfolio. The purposes of these analyses are:
- identifying loans which have a probability of transforming into underperforming loans;
- examining the loaning procedures used, with a view to ensure their conformity to the loaning policy of the bank;
- the taking of a general account of the quality of the loan portfolio and its structure;
- the evaluation of the competence of bank’s credit officers;

The organizing and purpose of the loan analysis program varies from bank to bank. The volume and quality of the bank’s loan portfolio, the costs and problems tied to personnel represent some of the factors that influence the date and frequency of the loan analyses and upon who is bestowed the responsibility of their undertaking. In case of force majeure situations, a bank must analyze all issued loans. Similarly, when a disparity is found with certain legal regulation, the bank must analyze its whole loan portfolio, in order to reestablish conformity in the respective field. The role of the credit officer in administering a loan is different from one bank to another. For example, in some banks, the credit officer has the task of making and keeping his own loan files, to analyze and evaluate totally independently the loans that he grants, as opposed to other banks, where these activities are much more centralized. Banks with larger and more diverse loan portfolio must organize a department that deals with loan analysis, made up of specialized staff, highly professional and which answers directly to the top leadership of the bank. A thorough loan analysis must have:

The assurance of conformity with the bank’s loaning policy;

Each bank must have a written document that contains the loaning policy, within which to bank leadership’s concept in this regard must be outlined and which puts at the disposal of workers an official set of procedures necessary for the loaning activity.

Most banking loan policies include: a description of the loan approval system, practiced by the bank in question; an explanation regarding its competence in loan granting; an explanation on the system of loan analysis, classification and accounting examination, practiced by the bank.

The document which contains the bank's loan policy is the only document which ensures the general framework for all practices used in the respective bank’s loaning activity. In absence of a unitary
loan policy, the bank will be, invariably, the victim of loan decisions taken at random and inconstantly. Thus, a credit officer could reject the granting of a loan demanded in perfectly valid conditions, from the point of view of the bank’s standards, while another officer could approve credits the sum of which may exceed his level of competence.

The purpose of the loan:
During the course of a loan analysis, it is essential that the purpose for which the loan was granted is verified to be the same as the one initially presented – the purpose of the loan must be obvious from the presented documents. For example, a loan granted for floating capital must be used for covering the bonds resulted from commercial loans, or the covering of necessities in the exploitative activity and not to finance the acquisition of a piece of machinery.

Proof of reimbursement:
The proof of payment for the reimbursement of the loan must be an object of the verification process, considering that it represents an indicator of the client’s capacity of reimbursement.

The client’s financial situation:
Within a loan analysis the financial situation of the client must also be evaluated, paying special attention to the improving or deteriorating of the profit and loss account, the liquidity flux situations, the main indicators, etc. Other fields of interest are the evolution of the competition, the economic and legislative environment changes as well as other external factors.

Documentation:
Checking all documents that make up the loan file is usually one side of the loan analysis. This ensures that all documents are adequately signed and prepared.

Securities:
Many of the losses resulted from the loaning activity appear when the securities are constituted based on inadequate documentation from which there is no clear image of their real value or based on outdated evidence which do not reflect the value depreciation of security type assets. This is why a loan analysis must include both the physical inspection of goods-type securities as well as the verification of their documentation. This analysis is made, usually, each month after the passing of the due date of filing the periodic accounting books and implies two phases:

Verifying the security of the object of the loan, the purpose of which is to rediscover the used loans in the firms’ floating assets, or in corporeal immobilization. The verification of loan securities is done by firsthand account and on the basis of data from the accounting books of the economic agent. Verifying collateral securities which is done by identifying in the field of the goods acquired through the loans: stocks of raw materials, unfinished products, finite goods and wares.

With regards to the physical inspection of goods and facilities, the loan inspectors must verify the existence of stocks in the structure declared in the business plans and confronted with the data from the firm’s accounting: the authenticity of the documentation for goods and stocks; if the identified stocks have assured consumption; the qualitative state and the storage conditions. The document verification is done on the basis of the accounting books and what is followed is the correct reflection in the books of the payments done through the use of loans and, secondly, the accordance of the account balance from the bank statements with the ones from the accounting books of the firm. In case a surplus of security is detected, this is a good sign for the activity of the economic agent. In case a security loss is detected, the banks moves for either the immediate reimbursement of the loan until a sum is reached that the value of the securities can cover or the rescheduling of the loan or the loan is added to the outstanding category.

Respecting legal regulations:
During a loan analysis, verification that the loan agreements between the bank and the client were conducted according to all valid and active legal provisions must be made.

5. Underperforming loans and recovery operations
The loaning activity generates both performing and, due to faulty risk management, problem loans and underperforming loans. Underperforming loans appear when there is a delay in the reimbursement and recovery of overdue debts and resolving payments is not assured or partially assured. Problem loans are those that, at the date of analysis, present obvious sings referring to the impossibility of future reimbursement at due date, following the deterioration of the client’s activity. For reducing the level of underperforming loans and their impact on the profitability of the bank, a prudent and efficient loaning policy is necessary, which would lead both to the prevention of this kind of loans and to the possibility of their recovery. Even so, underperforming loans represent an inevitable consequence of loaning activity. Each loan implies the appearance of certain unforeseen events, which make it difficult for the client to stay true to the terms of the loan contract.

Certain underperforming loans may appear as a result of the credit officer’s errors. It is possible for a credit officer to inadequately evaluate the character of the client or wrongly interpret the numbers in
the case of a financial analysis. These, as other similar causes which lead to the appearance of underperforming loans, can be and must be reduced to a minimum.

An underperforming loan can appear even when the officer does not make a mistake in any of the phases of loan evaluation. For example, no credit officer can foresee an unfavorable period for agricultural crops or a decrease in the value of land which can be the cause of an underperforming agricultural loan.

A competent credit officer can maintain the number of underperforming loans to an acceptable level and reduce to a minimum the losses registered by the bank, bearing in mind that the quality of the granted loan does not decrease. Some underperforming loans are inevitable, but the losses registered by the bank are negligible if they are identified in time. In this situation, the credit officer has several alternatives, for example he may establish, along with the client, a forecasted cash flow situation or a rescheduling of loan installments. When the bank is obligated to liquidate securities, the possibility that it may not entirely recover its non-reimbursed assets, interest and administration costs rises.

The process of loaning is, by its very nature, imperfect. Loan analysis may be incomplete or based on erroneous data; the credit officer may ignore the true conditions of a debtor, so the debtor’s reimbursement capability can effectively change after the loan has been granted. If management is focused exclusively on the total elimination of risk, a bank will not grant loans anymore, profits will shrink and the loan needs of the clients will not be satisfied.

Creditors can never completely eliminate risk, thus, some loan loss may appear. The objective of a bank is to establish the optimum of the risk – income ratio. With the purpose of efficient administration of assets and liabilities, in each bank the Committee for Asset and Liabilities Administration functions.

Within American banks, ALCO (Asset and Liability Committee) monitors and determines the exchange rate risk, offers recommendations for price fixing, investments, funds and marketing strategies, so as to establish the desired correlations between risk and expected profit.

The loan revision procedures identify the moment when the loan begins to deteriorate and helps institute corrective actions. Most problem loans can be restructured through an efficient use of the period up to the improvement of debtor's financial conditions. Thus, problem loan analysis relies on the detection of problem situations and the modification of initial terms, in order to improve the perspective of reimbursement.

The credit officer constantly monitors the circumstances of each debtor, in order to detect possible problems with the loan, before they become impossible to correct. He informs, in the loan file, about the quality of financial data, the history of the loan, the fill-out of documentation and the value of securities. If there are any weaknesses with the loan, he may classify it as substandard, doubtful or loss. Then the bank will have to allocate reserves in different percentages, proportional with the granted loan, against potential loss.

The biggest costs appear in the situation when an underperforming credit can no longer be recovered, but each underperforming credit implies other costs, much harder to detect, which may very well lead to the decrease in the bank’s profit.

Well running banking activity is based on trust. A bank may attract the capital it requires for loaning or other investments only if its depositors trust its ability to use the money. This means, before anything else, a minimum level of underperforming loans. Too large a number of these loans leads to the deterioration of the image that the bank has in front of its clients. In this situation, the bank’s profitability decreases, difficulties in attracting depositors arise and it is prevented from developing its activity.

An underperforming loan implies increased attention on the part of the bank staff. The credit officer must devote more time to the direct collaboration with the client, and the additional verifications and follow-up analyses require the deployment of a larger number of bank employees. The additional time which is devoted to an underperforming loan is practically unproductive, since it is only used to protect the bank’s assets, without generating a corresponding supplementary income. Furthermore, additional costs may arise when evaluators, consultants or other external specialists are called on.

There are numerous factors which may generate the appearance of an underperforming loan. Most often, the appearance of such a loan is, rather, the result of the concerted action of a multitude of factors, rather than just one. Many of these factors fall outside of the bank’s sphere of control. One single factor – the errors committed by the bank staff – can be kept at a minimum level if the credit officer went through and executed carefully and thoroughly each phase of the loaning process.

Avoiding the appearance of underperforming loans begins with a close and thorough evaluation of the loan request. Any stage of the loaning process executed inadequately, from an unsatisfactory interview to an inadequate loan monitoring process may have as a result an underperforming loan.

Preliminary discussions with the client prove to be inadequate when the credit officer, instead of focusing on specific questions, with the clear purpose of obtaining information about the client's financial situations prefers a friendly conversation with him. Another deficiency is the inability to ask significant questions or to follow a particular line when the answers received are wrong or dodgy. The preliminary interview is the best opportunity for the credit officer to evaluate the client’s character traits. If the
interview is conducted inadequately, it may lead to the wrong conclusions about the client’s goodwill to reimburse the credit.

Many of the underperforming loans appear when the credit officer does not consider that the financial analysis is an important factor in making the final decision of whether to grant or repeal the request for a loan. Nothing can replace a complete financial analysis during the loaning process. An inadequate financial analysis consists of the superficial interpretation of the balance and profit and loss account as well as not verifying the correctness of the financial accounting books.

Rarely loans become underperforming or generate losses overnight. There exists, almost always, a gradual deterioration of the quality of the loan, which is followed by numerous warning signs. Maintaining a permanently open channel of communication between the bank and the beneficiary of the loan is a very good practice from many points of view, especially due to the fact that it brings together all non-financial information which may indicate the possible appearance of an underperforming loan.

After the appearance of an underperforming loan has been identified, the immediate next step is the scheduling of a rendezvous with the loan beneficiary. The credit officer must act promptly and directly. It is not enough to send a letter in which to warn the client that they broke certain clauses of the loan contract. The results will most likely be unsatisfactory, because most clients either refuse to admit that there is a problem or believe that, in time, they will be able to remedy them themselves. The client may even not respond to the letter. But the credit officer has the duty to contact the client by phone, to inform him of the problems that have the bank concerned and to schedule a rendezvous with them. The first rendezvous with the client is the most important, because it establishes the platform for all subsequent ones. During this first one, the two parties must have a discussion regarding the emergent problem, study the possible alternatives with a purpose to solve it and determine the actions to be taken. The credit officer must make a decision regarding additional information, such as the financial books that the client must produce so that the bank can more closely follow the problems. The final decision that the credit officer will take depends on how thoroughly the problems and possible solutions for their solving have been analyzed.

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